



Testimony of

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On behalf of the
Independent Community Bankers of America

Before the

**Congress of the United States
House of Representatives
Committee on Small Business**

Hearing on

**“Sarbanes-Oxley Section 404: New Evidence on the Costs for
Small Businesses”**

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Good morning. My name is Bill Loving and I am Executive Vice President and Chief Executive Officer of Pendleton Community Bank in Franklin, West Virginia. Chairwoman Velazquez, Ranking Member Chabot, I appreciate the opportunity to testify on behalf of the Independent Community Bankers of America (ICBA)¹ concerning Section 404 of the Sarbanes-Oxley Act of 2002 (SOX) and the results of the Chamber of Commerce Cost of SOX 404 Survey dated November 8, 2007. Section 404(a) requires publicly held companies to include an assessment by management of the effectiveness of their company's financial controls and procedures in their annual reports and Section 404(b) requires the company's auditor to attest to the effectiveness of the company's internal controls and procedures.

Summary of Testimony

- The Chamber Survey, which indicates that this year's and next year's costs to implement SOX 404 will exceed \$200,000 per year confirms the results of ICBA's 2005 SOX 404 Survey of Community Banks and reflects the excessive and disproportionate burden that community banks are experiencing with SOX 404.
- Like many publicly held community banks, Pendleton Community Bank is a good example of a small public company that is overburdened with the regulatory requirements of SOX 404.
- ICBA strongly supports Chairwoman Velazquez's request to the SEC to delay the implementation next year of the auditor attestation requirements required by Section 404(b) for non-accelerated SEC filers.
- ICBA applauds Chairwoman Velazquez's efforts to obtain hard dollar estimates from the SEC of the impact that SOX 404 has on smaller public companies. The SEC should have made those estimates prior to adopting Auditing Standard No. 5 or AS-5.
- To indicate that it is serious about reducing costs, ICBA believes that the SEC and the PCAOB should establish quantitative benchmarks or goals for the AS-5 that is tied to a reduction in overall SOX 404 audit costs. ICBA still has doubts that AS-5 will reduce 404 audit costs, particularly for smaller public companies.

¹ *The Independent Community Bankers of America represents 5,000 community banks of all sizes and charter types throughout the United States and is dedicated exclusively to representing the interests of the community banking industry and the communities and customers we serve. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace.*

With nearly 5,000 members, representing more than 18,000 locations nationwide and employing over 268,000 Americans, ICBA members hold more than \$908 billion in assets, \$726 billion in deposits, and more than \$619 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org.

- ICBA supports the Community Banks Serving their Communities First Act of 2007 (HR 1869) introduced by Chairwoman Velazquez which would relieve community banks with assets of less than \$1 billion from the requirements of SOX Section 404 and would raise the shareholder threshold from 500 to 1,000 under the Exchange Act.

New Evidence from the Chamber of Commerce SOX 404 Survey Reflects SOX Burden on Community Banks

On November 8, 2007, the U.S. Chamber's Center for Capital Markets Competitiveness released the results of its on-line survey on the projected 2007 and 2008 costs of SOX Section 404 and its impact on small businesses. Since approximately 25% of the respondents to the survey were from the financial services industry and many of these respondents were community banks, ICBA believes the survey's results are a good reflection of the costs that publicly held community banks are now experiencing this year trying to comply with Section 404(a) and will be experiencing next year as a result of complying with Section 404(b).

The Chamber Survey indicated that over half of the respondents expect internal and external costs to implement SOX 404(a) this year to exceed \$200,000 while 44% of respondents expect next year's implementation costs of 404(b) to also exceed \$200,000. For non-accelerated filers that responded to the Chamber Survey, this amounted to more than 3 percent of net income. These results confirm ICBA's 2005 SOX 404 community bank survey which showed that the average community bank would be spending more than \$200,000 and devoting over 2,000 internal staff hours to comply with Section 404. Since most community banks are "non-accelerated SEC filers" (e.g., those with public float or market capitalization of less than \$75 million), we believe the Chamber Survey accurately reflects the fact that community banks will be spending in a range of about 3%-5% of their net income on SOX 404 compliance.

The Chamber Survey also indicated that nine out of ten respondents expect costs will "greatly exceed" or "moderately exceed" the benefits of SOX 404 compliance. This was also the conclusion of many of the community banks that participated in ICBA's 2005 survey-- that the costs of Section 404 compliance significantly outweigh any benefits to their companies or their internal control processes. Furthermore, time devoted to Section 404 compliance is diverting management from its duties of running a bank. Community banks, just like other smaller companies, operate on slim profit margins and simply do not have the time and resources to comply with Section 404. The Chamber Survey quoted one community banker as saying that "while the purpose of SOX is well-intended to put in place reliant control structure, compliance for an institution of our size and structure (e.g., asset size is \$45 million) has created extremely negative earnings consequences because there has been little to no consideration for asset size, human or dollar resources."

The Chamber Survey Accurately Reflects the Regulatory Burden of SOX 404 on Pendleton Community Bank

I can tell you that as CEO of a community bank that is also a non-accelerated, SEC filer, the Chamber Survey accurately reflects the disproportionate burden that community banks like mine are facing to comply with Section 404. This year, Pendleton Community Bank and its holding company, Allegheny Bancshares, Inc., have spent about \$70,000 to comply with Section 404 that includes costs associated with 580 man hours. While the impact on net income for 2007 is approximately 3.0%, the combined costs incurred to date would, if accounted for in one calendar year, be \$168,640 or 6.88% of 2007's projected net income. This total cost includes \$82,987 on vendor and accounting expense, \$3,500 on training and education expense, 1,380 man hours, and substantial board and committee fees. We anticipate costs next year to approximate \$50,850 to insure compliance with Section 404, resulting in total costs of around \$218,310 or 8.95% of anticipated 2007 net income for our holding company. These costs do not reflect the time and money associated with the selection and appointment of a new external audit firm—a consequence of Section 404 since our old firm ceased auditing publicly held companies because of the liability and regulatory requirements of SOX 404. Just as the majority of respondents indicated in the Chamber Survey, we have already been conferring with our outside accountant on our internal control audit for next year.

Like many publicly held community banks, Pendleton Community Bank is a good example of a small public company that should not be subject to the reporting requirements of Section 12 of the Securities Exchange Act of 1934 and to all the regulatory burdens of SOX. Our holding company has 710 registered shareholders the majority of which reside in or are related to residents of Pendleton County. With 66 employees and four branches, it is a severe strain for our bank and holding company to comply with all the reporting and disclosure requirements of the Exchange Act.

Our bank has considered going private to avoid these costs. However, considering the small community where our bank is located—Franklin, West Virginia has a population of less than 1,000 and Pendleton County's population, based on 2006 estimates, is only 7,679—it would be a significant loss both to our community and to the bank's reputation if our bank were to go private and repurchase most of its stock or participate in a reverse stock split—a process that forces out shareholders below a certain level of ownership. Many of our local residents, who have taken pride in their ownership of the bank, would cease to own a share of stock in one of the few publicly held companies in the county. Not only would this be costly to our bank, it would be a devastating blow to the reputation and image of the community and to many of the stockholders/customers of the bank who have supported the bank since its establishment.

ICBA Supports Chairwoman's Velazquez's Call to Delay Implementation of Section 404(b)

ICBA was disappointed that the SEC did not adopt ICBA's recommendation to delay by one year the Section 404 due dates for non-accelerated filers so that calendar year filers would have until the due date for their 2008 annual report rather than the due date of their 2007 annual report to file their management internal control reports. **Now that we have reached the end of 2007 and most non-accelerated filers have completed their management internal control reports, ICBA strongly supports Chairwoman Velazquez's request to the SEC to delay the implementation of the auditor attestation requirements required by Section 404(b), which for calendar year filers would begin in 2008. The one-year delay would accomplish several things.**

First, since the SEC and the Public Company Accounting Oversight Board or the PCAOB have just adopted a new auditing standard under Section 404 (e.g., Auditing Standard No. 5 or AS-5) and new guidance for management reporting of internal controls, it would give the SEC and the PCAOB an opportunity to evaluate the impact of this new guidance on accelerated and large accelerated filers. If, for instance, the SEC Guidance and AS-5 have little impact on SOX 404 audit costs during 2007 or 2008, then the SEC and the PCAOB would have time to revise the guidance and the new auditing standard before it is fully implemented by non-accelerated filers.

Second, a one-year delay would also have given non-accelerated filers that have no experience with Section 404 additional time to understand and apply AS-5 and the new guidance and establish a new internal control framework. As it stands, non-accelerated filers will have a very limited time to work with their auditing firms in preparing internal control documentation under the new standard. Furthermore, it would enable small auditing firms that have yet to perform a Section 404 audit an additional year to analyze the PCAOB's October 17th guidance to auditors in performing audits of smaller, less complex companies and participate in PCAOB-sponsored small-business auditing forums. We note that 79% of the respondents to the Chamber Survey felt that a delay in the compliance deadline for SOX 404(a) and 404(b) would be helpful to their company.

The SEC Should Track Cost Data on the Impact of Section 404 on Smaller Public Companies and Should have Benchmarks for AS-5

ICBA also applauds Chairwoman Velazquez's efforts to obtain hard dollar estimates from the SEC of the impact that SOX 404 has on smaller public companies. The SEC should have made those estimates prior to adopting AS-5. So far, the SEC has not produced any specific quantifiable data to support their prediction that audit costs will go down as a result of adopting AS-5. However, as a result of Chairwoman Velazquez's efforts, SEC Chairman Christopher Cox has committed the Commission to data collection program beginning after the non-accelerated filers first file their Section 404(a) management reports either in their proxy statements or their annual reports of Form 10-Ks for 2008. According to Chairman Cox, this data will be collected and analyzed by the Commission's Office of Economic Analysis with the assistance from the Office of Small Business Policy in the Division of Corporation Finance and the Commission's Office of the Chief Accountant.

ICBA hopes that the Section 404(a) cost data will be available by the spring of 2008 and that the SEC will compare the cost data from the non-accelerated filers with the data from the accelerated and large accelerated filers. **ICBA believes that the SEC and the PCAOB should establish quantitative benchmarks or goals for the AS-5 that is tied to a reduction in overall SOX 404 audit costs.** For instance, the SEC and the PCAOB should state that the goal of AS-5 is to reduce average internal control audit costs by a certain percentage—say 20%, with a commitment that if the revised standard does not meet that goal, then the standard would be revised further. It is too ambiguous for the SEC or the PCAOB to state that their goal is to increase the “cost effectiveness of the 404 audit” or “to eliminate unnecessary audit procedures” particularly when there has been no field testing of the new standard and therefore no assurance that it will reduce costs. Specific benchmarks or goals would convey to the industry that the SEC and the PCAOB is serious about reducing the overall costs of SOX 404 and is committed to achieving that goal.

ICBA Continues to Have Doubts about the Cost Impact of AS-5

In our statement to this Committee dated June 5, 2007², ICBA commended the SEC and the PCAOB for their efforts to create a scalable, top-down approach for SOX 404 audits. As noted in the release for the SEC Guidance, the SEC Advisory Committee on Smaller Public Companies raised a number of concerns regarding the ability of smaller companies to comply cost-effectively with the requirements of SOX 404. Some of the concerns stemmed from the implementation of Auditing Standard No. 2 and the fact that auditors were engaged in excessive testing of controls and requiring unnecessary documentation to comply with SOX 404.

While the SEC Guidance and proposed AS-5 may curtail excessive testing of controls and reduce some of the unnecessary documentation required by SOX 404 audits, we still have doubts that it will reduce 404 audit costs, particularly for smaller public companies. We note, for instance, that AS5 has not been field tested so there is no evidence to suggest that, despite the proposed standard’s focus on scalability and risk-based testing, auditors will significantly change their audit procedures or reduce the time they take to perform a 404 audit. Furthermore, there has been nothing done to reduce the liability of auditors which we feel is just as important to reducing auditing costs as curtailing excessive control testing.

² See statement of ICBA in connection with the hearing by the House Small Business Committee (June 5, 2007) on SOX 404 and whether the SEC’s and the PCAOB’s new standards would lower compliance costs for small companies.

ICBA Supports the Communities First Act and a SOX 404 Exemption for Community Banks

ICBA supports the Community Banks Serving their Communities First Act of 2007 (HR 1869) introduced by Chairwoman Velazquez which would relieve community banks with assets of less than \$1 billion from the requirements of Section 404(b).

The Communities First Act would make SOX 404 consistent with the FDIC Improvement Act of 1991 (FDICIA) and the corresponding banking regulations which exempt banks with less than \$1 billion in assets from the internal control attestation requirements of that law. The banking regulators recently raised the small bank exemption under FDICIA to \$1 billion from \$500 million in recognition of the fact that the industry is already highly regulated, that community banks pose less of risk to the Deposit Insurance Fund, and that internal control audits are very expensive for community banks. Whether it is the regulations under the Bank Secrecy Act, the USA Patriot Act, or SOX, community banks have so much regulation to contend with that more and more of them are considering merging or consolidating with larger entities.

ICBA strongly endorsed the primary recommendations of the SEC's Advisory Committee on Smaller Public Companies issued in 2005 including (a) exempting micro-cap companies (with equity capitalizations of \$128 million or less) that have revenue of less than \$125 million from the internal control attestation requirements of SOX Section 404 and (b) exempting small-cap companies (with equity capitalizations of between \$128 million and \$787 million) that have revenue of less than \$250 million from the external audit requirements of SOX Section 404. Rusty Cloutier, ICBA's former Chairman, represented the financial institutions industry on the Advisory Committee. We agree with the Advisory Committee that with more limited resources, fewer internal personnel and less revenue with which to offset the costs of Section 404 compliance, both micro-cap and small-cap companies have been disproportionately impacted by the burdens associated with Section 404 compliance. We also agree that the benefits of documenting, testing and certifying the adequacy of internal controls, while of obvious importance for large companies, are of less value for micro-cap and small-cap companies, that rely to a greater degree on "tone at the top" and high-level monitoring controls, to influence accurate financial reporting.

The proportionately larger costs for smaller public companies to comply with Section 404 adversely affect their ability to compete with larger public companies and even with foreign competition. This reduction in the competitiveness of U.S. smaller public companies hurts their capital formation ability and, as a result, hurts the U.S. economy. Even with a new internal control auditing standard, we believe that smaller public companies would still be subject to unnecessarily extensive auditing of detailed control processes under Section 404 by auditors unduly concerned about their liability and being second guessed by the PCAOB.

ICBA Also Strongly Supports Raising the Registration Threshold Under the Exchange Act

ICBA also strongly supports raising the threshold for reporting companies under the Securities Exchange Act of 1934. Currently, companies with \$10 million in assets and 500 shareholders are required to comply with that law. Although the asset size has been updated from \$1 million to \$10 million, the shareholder threshold has not been updated since the threshold was established in 1964.

In addition to providing an exemption for community banks from Section 404(b), the ICBA-endorsed Communities First Act would raise the shareholder threshold under the Exchange Act to 1,000 from its present level of 500. This amendment to the Exchange Act would provide significant regulatory relief for hundreds of community banks like Pendleton Community Bank that are struggling with Exchange Act and SOX compliance.

Conclusion

ICBA believes that the new evidence from the Chamber's SOX Survey should be a wake up call to the SEC concerning the excessive and disproportionate burden that community banks and other small companies are experiencing with SOX 404. Now that we have reached the end of 2007 and most non-accelerated filers have completed their management internal control reports, ICBA strongly supports Chairwoman Velazquez's request to the SEC to delay the implementation of the auditor attestation requirements required by Section 404(b) which for calendar year filers, would begin in 2008. The one-year delay would give the SEC and the PCAOB an opportunity to assess the impact of AS-5 on internal control audits of accelerated and large accelerated filers and would enable small auditing firms that have yet to perform a Section 404 audit an additional year to analyze the PCAOB's October 17th guidance to auditors in performing audits of smaller, less complex companies and participate in PCAOB-sponsored small-business auditing forums.

ICBA believes that the SEC should conduct a comprehensive data collection program in connection with the implementation of SOX 404 for non-accelerated filers beginning this year and should establish benchmarks for AS-5. ICBA strongly supports the Community Banks Serving their Communities First Act of 2007 or HR 1869 introduced by Chairwoman Velazquez that would relieve community banks with assets of less than \$1 billion from the requirements of SOX Section 404(b) and would raise the shareholder threshold from 500 to 1,000 under the Exchange Act.

ICBA appreciates this opportunity to testify before the House Small Business Committee concerning the impact that Section 404 of the Sarbanes-Oxley Act will have on small businesses and the new evidence from the Chamber's Survey of Small Businesses.